

ACCEPTANCE OF GIFTS OR ENTERTAINMENT BY FUND ADVISORY PERSONNEL — SECTION 17(e)(1) OF THE INVESTMENT COMPANY ACT

In furtherance of the Division's mission to protect investors, the staff periodically issues guidance updates that highlight particular situations that might give rise to conflicts of interest. In this guidance update, the staff is highlighting the conflict of interest that arises when the personnel of a fund's investment adviser are presented with gifts, favors or other forms of consideration (gifts or entertainment) from persons doing business, or hoping to do business, with the fund. It is not uncommon for the codes of ethics of investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act") and funds under the Investment Company Act of 1940 (the "1940 Act") expressly to address this particular conflict of interest.¹

The staff is issuing this guidance to remind mutual fund industry participants that the receipt of gifts or entertainment by fund advisory personnel, among others, also may implicate the prohibition in section 17(e)(1) of the 1940 Act.² In the staff's view, therefore, it should be addressed by funds' compliance policies and procedures required by rule 38a-1 under the 1940 Act.

The Prohibition in Section 17(e)(1)

Section 17(e)(1) is one of the many provisions of the 1940 Act prohibiting a fund's investment adviser and its officers, directors and employees, among others, from engaging in certain transactions involving the fund. Specifically, section 17(e)(1) states that "[i]t shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person . . . acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker." Under section 2(a)(3)(E) of the 1940 Act, a fund's investment



adviser is an affiliated person of the fund. Under section 2(a)(3)(D), the investment adviser's officers, directors and employees, among others, are affiliated persons of the investment adviser and are second-tier affiliates of the fund.

The prohibition in section 17(e)(1) generally applies whenever fund advisory personnel, acting as agent,³ accept from any source any compensation (other than regular salary or wages from the fund) for the purchase or sale of any property to or for the fund.⁴ For example, if a fund's portfolio manager accepts any gifts or entertainment⁵ from a broker-dealer for the purchase or sale of the fund's portfolio securities,⁶ the portfolio manager has violated section 17(e)(1). The prohibition reflects one of Congress' fundamental policy concerns when it enacted the 1940 Act, expressed in section 1(b)(2) of the 1940 Act—the potential for funds to be managed, or their portfolio securities selected, in the interest of their investment advisers and their affiliates or other persons rather than in the interest of the fund's shareholders.⁷

Compliance Policies and Procedures

Rule 38a-1 under the 1940 Act requires a fund's board of directors to approve, and each fund to adopt and implement, written policies and procedures reasonably designed to prevent the fund and its service providers from violating the federal securities laws. Rule 38a-1 also requires fund boards to approve the policies and procedures of fund service providers, including investment advisers, and requires the fund's compliance policies and procedures to include provisions for fund compliance oversight of its service providers.⁸

The receipt of gifts or entertainment by fund advisory personnel, among others, may violate section 17(e)(1) of the 1940 Act and, in the staff's view, should be addressed by funds' compliance policies and procedures under rule 38a-1. The particular policies and procedures concerning the receipt of gifts or entertainment that might be appropriate would depend on the nature of the adviser's business, among other considerations. Some funds and advisers might find a blanket prohibition on the receipt of gifts or entertainment by fund advisory personnel to be appropriate. Other funds and advisers might find other measures to be more appropriate, such as some type of a pre-clearance mechanism for acceptances of gifts or entertainment to assess whether they would be for the purchase or sale of any property to or for the fund and therefore prohibited under section 17(e)(1).

Endnotes

- 1 Rules 204A-1 under Advisers Act and 17j-1 under the 1940 Act require codes of ethics for investment advisers and registered investment companies, respectively.
- 2 Such conduct also may result in various violations of the Advisers Act. See, e.g., *In the Matter of Fidelity Mgmt. & Research Co. and FMR Co., Inc.*, Advisers Act Release No. 2713 (Mar. 5, 2008) (<http://www.sec.gov/litigation/admin/2008/ia-2713.pdf>). The prohibition in section 17(e)(1) also is broader than the provisions in the rules promulgated by the Financial Industry Regulatory Authority, Inc. (the “FINRA”) concerning gifts and gratuities and non-cash compensation for broker-dealers. See FINRA Rule 3220 (gifts and gratuities) and FINRA Rules 2310, 2320, 5110, and NASD Rule 2830 (non-cash compensation).
- 3 “[A]n affiliated person is acting as agent within the meaning of § 17(e)(1) in all cases when he is not acting as broker for the investment company.” See *United States v. Deutsch*, 451 F.2d 98, 111 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972).
- 4 The mere receipt of compensation for the purchase or sale of property to or for a fund is a violation of section 17(e)(1), so that it is not necessary to show that the person receiving the compensation influenced the actions of the fund, or that the fund suffered economic injury. See *Deutsch*, 451 F.2d at 109-10.
- 5 The Commission has found that gifts or entertainment meets the broad definition of “compensation” in the context of section 17(e)(1). See, e.g., *In the Matter of Robert L. Burns*, Advisers Act Release No. 3260 (Aug. 5, 2011) at n. 11 and accompanying text (<http://www.sec.gov/litigation/opinions/2011/ia-3260.pdf>) (equity trader, who was an affiliated person of an investment adviser, willfully violated Section 17(e)(1) by accepting gifts from brokerage firms to which he transmitted orders to buy and sell securities on behalf of certain of the investment adviser’s mutual fund clients).
- 6 Because section 17(e)(1) prohibits the receipt of compensation in exchange “for” the purchase or sale of property to or for a fund, courts have found “some nexus must be established between the compensation received and the property bought or sold.” See *Decker v. SEC*, 631 F.2d 1380, 1384 (10th Cir. 1980). This provision does not require any proof of any “intent to influence.” *Id.* (citing *Deutsch* at 112-13). Further, direct evidence of a nexus will “ordinarily not be available” and “often be disguised by arrangements that are ‘facially proper.’” *Id.* at 1385. In part because of this difficulty of proof, “once a conflict of interest is proven, the burden shifts to the party in conflict to prove that he has been faithful to his trust.” *Id.* (quoting *Investors*

Research Corp. v. SEC, 628 F.2d 168, 175 (D.C. Cir. 1980)). See also generally *In the Matter of Robert L. Burns*, Advisers Act Release No. 3260 (Aug. 5, 2011), *supra* note 5, at 9-10.

- 7 The scope of section 17(e)(1) is by no means limited to gifts or entertainment. See, e.g., the following Commission proceedings: *In the Matter of Kimball L. Young*, Advisers Act Release No. 3133 (Jan. 7, 2011) (<http://www.sec.gov/litigation/admin/2011/34-63675.pdf>) and *In the Matter of Thomas S. Albright*, Advisers Act Release No. 3134 (Jan. 7, 2011) (<http://www.sec.gov/litigation/admin/2011/34-63676.pdf>) (finding portfolio managers of municipal bond fund violated section 17(e)(1) in improperly charging credit monitoring fees to, and individually receiving compensation from, bond issuers in connection with fund bond holdings for which monitoring was already performed as part of each manager's regular responsibilities for the fund); *In the Matter of Value Line, Inc.*, Advisers Act Release No. 2945 (Nov. 4, 2009) (<http://www.sec.gov/litigation/admin/2009/33-9081.pdf>) (finding registered investment adviser and affiliated broker-dealer violated section 17(e)(1) when adviser directed fund brokerage commissions to broker-dealer for which no brokerage services were provided); *In the Matter of Duff & Phelps Investment Mgmt. Co.*, Advisers Act Release No. 1984 (Sept. 28, 2001) (<http://www.sec.gov/litigation/admin/ia-1984.htm>) (finding registered investment adviser violated section 17(e)(1) in directing fund commissions to a broker-dealer in exchange for referrals); *In the Matter of Parnassus, et al.*, Admin. Proc. File No. 3-9317 (Sept. 3, 1998) (finding registered investment adviser to, and portfolio manager of, mutual fund violated section 17(e)(1) when using soft dollar credits that fell outside of the "safe harbor" of section 28(e) of the Securities Exchange Act of 1934) (<https://www.sec.gov/litigation/aljdec/id131rgm.txt>). See also *In the Matter of Patricia A. Ostrander*, Advisers Act Release No. 1371 (May 3, 1993) (barring portfolio manager from association with, among others, any investment adviser based upon criminal conviction under section 17(e)(1) resulting from accepting an investment opportunity because of past and expected future securities transactions).

- 8 Separately, rule 206(4)-7 under the Advisers Act requires investment advisers registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser or any of its supervised persons. Section 203(e)(6) of the Advisers Act provides for the imposition of sanctions on an investment adviser or persons associated with the adviser for failing to reasonably supervise other persons under their supervision from violating, among others, the Advisers Act or the 1940 Act.

This *IM Guidance Update* summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This *IM Guidance Update* is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this *IM Guidance Update*.

The Investment Management Division works to:

- ▲ protect investors
- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services through regulating the asset management industry.

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